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Incorporation of a Portfolio Consisting of Marketable Securities-A Useful Tax-planning Technique

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INCORPORATION OF A PORTFOLIO CONSISTING OF MARKETABLE SECURITIES—A USEFUL TAX-PLANNING TECHNIQUE

MALCOLM H. NEUWAHL*

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I. INTRODUCTION

Does a person with a substantial amount of marketable securities have any opportunities to save taxes which are incurred as a result of the ownership of his portfolio? The reaction of most tax practitioners would probably be that there are no planning devices which are peculiar to this type of investment. In fact, the government has already closed one big loophole by enacting the personal holding company provisions.¹

That legislation, in combination with the classic double taxation effect which a corporation produces,² is generally thought to make the use of the corporate vehicle totally impractical for the purpose of holding these types of liquid assets. However, as will be demonstrated by the analysis of this article, the incorporation of a portfolio may produce highly beneficial tax results in the proper circumstances, provided that the estab-

1. INT. REV. CODE OF 1954, § 541 *et seq.*, and section V *infra*. [All references to the INTERNAL REVENUE CODE OF 1954 are hereinafter cited in the text by section (§) without further description].

2. For a full explanation and analysis of the "Double Taxation Effect," see B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 1.03 (3d ed. 1971) [hereinafter cited as BITTKER & EUSTICE].

lishment of the plan is tempered with competent advice and later subjected to periodic review.

II. OBJECTIVES, ESTABLISHMENT AND OPERATION OF THE PLAN

A. Objectives

The basic goals of the plan are threefold: (1) to reduce the burden of federal estate taxes on the assets subjected to the plan with a minimum of gift tax consequences; (2) to avoid adverse income tax consequences, and possibly provide some substantial income tax benefits to the original owner of the portfolio and his family unit; and (3) to allow the owner to maintain the same economic control and flexibility in making investment decisions with regard to the portfolio as he would have had if his individual ownership had continued. For convenience, the initial owner of the stocks and securities who will be the main object of the plan set out in this article will be referred to as the owner-transferor.

B. Establishment and Basic Corporate Structure

The estate tax advantages of the plan would be accomplished through the capital structure of the corporation. Therefore, one consideration in determining the types of stocks and securities to be transferred to the corporation should be estate planning.³

A combination of non-convertible preferred stocks and debt securities with a total face amount and/or liquidation value approximating the total fair market value of the portfolio should be transferred to the owner-transferor by a newly-formed corporation in a transaction which has no tax effects.⁴ The remaining stock (which will be common) is issued to the objects of the owner-transferor's bounty (his family).

The effect of this type of capitalization for estate planning is to prevent the value of the owner-transferor's estate from increasing any further since, by their nature, the preferred stock and debt securities which will be transferred to him will not appreciate substantially if at all. In effect, all future appreciation of the owner-transferor's portfolio has been shifted to his family at no gift tax or estate tax cost. Additionally, the value of the stock and securities he would hold in this close corporation may have a lower value for estate tax purposes than that of the underlying marketable stocks and securities to be held by the corporation.⁵

In order to retain control of the portfolio, the owner-transferor's preferred stock would be voting, and the common issued to his beneficiaries would be non-voting. It should be noted that such retention of voting control may amount to a "tainted retained power" in connection with a

3. See section II(D) *infra*.

4. See INT. REV. CODE OF 1954, § 351; section III *infra*.

5. See section X *infra*.

gratuitous transfer which would cause the common stock to be included in the owner-transferor's estate under § 2036(a) or § 2038. A full discussion of the application of these sections and the possible means of avoiding their application will be taken up at a later point in this article.⁶

The interest and dividend rates on the debt securities and the preferred stock would be sufficient to provide the owner-transferor with the income that he desires. Also, the owner-transferor has the option to make gifts of his stock in the newly formed corporation at a later time without the risk of further appreciation which would cause greater estate and gift tax burdens.

C. *Alternatives and Modifications Regarding Capital Structure— Basic Considerations*

Several variations on this basic type of capitalization are also possible. One would be to make the preferred stock senior to the common as to assets upon liquidation, but not as to dividends. This would provide for flexibility in shifting income among family members, but would not jeopardize the owner-transferor's needs for income since he would retain voting control of the corporation as stated above. It should be noted that this type of arrangement would not be feasible with regard to the debt securities since it would probably result in their being classified as equity securities.⁷

Another alternative would be to make only a small portion (in terms of value) of the preferred stock voting. This would facilitate the making of gifts of the stock in the future without requiring the owner-transferor to relinquish any degree of corporate control.

Certainly there are other possible variations and additional considerations in the area of determining the exact nature of the initial capital structure, but they must be made in light of all the circumstances existing at the time the transfer is effected. Some of these additional factors are considered in the discussion which follows.

1. GIFT TAX VALUATION OF COMMON STOCK

Assuming there is a gift inherent in the transfer of the common stock, what value should be given to it for gift tax purposes? This is a matter which is largely within the control of the owner-transferor at the time of the initial transfer. One reasonable approach would be to value the common stock as the excess of the fair market value of all the corporate assets over the liquidation values of all the senior stock and securities. Since the holders of the common shares would have no voting rights and therefore no control over the corporation, a substantial discount from the value as determined above could probably be justified. Under this method,

6. See section XI *infra*.

7. See section IV *infra*.

the gift tax value of the common could be varied in order to produce the desired gift tax consequences.⁸ One possible approach would be to make the value of the common equal to the maximum amount the owner-transferor could give away with no gift tax effect.⁹

2. DEBT VERSUS EQUITY

How much debt (in comparison with equity) should be issued? The answer to this question is governed, in part, by tax considerations, *i.e.*, the thin capitalization rules.¹⁰ The interest should be sufficient to minimize the adverse effects of double taxation, but, as mentioned previously, the fixed interest obligation of debt securities may prevent some advantageous use of income splitting. In making decisions on the initial capitalization, these and other factors must be considered in light of the particular circumstances.

3. INTEREST AND DIVIDEND RATES ON FIXED INCOME SECURITIES

What should the stated interest and dividend rates be on the debt securities and preferred stock? Some reasonable interest rate should be provided for on the debt to avoid serious valuation problems and to avoid the possible application of the imputed interest rules.¹¹ Also the interest should be sufficient to minimize the effects of double taxation.¹² Other possible considerations in determining the interest and dividend rates are the owner-transferor's needs for income, the effect on the income shifting possibilities,¹³ and the availability of funds to satisfy these obligations.

D. *Type of Assets to be Transferred to the Corporation*

What types of stocks and securities should be transferred to the corporation? Since the basic objective of the plan is to avoid estate taxes on future appreciation of the portfolio, there would be no point in transferring large amounts of non-appreciating stocks and securities (such as non-convertible bonds and preferred stocks) to the corporation. The bulk of the stocks and securities transferred to the corporation should be

8. See section X *infra* for a general discussion of valuation of closely held stock. It should also be noted that there are other possible methods of valuation for gift tax purposes—for example, all of the stocks and securities issued by the incorporated portfolio could be independently valued. It would seem, however, that any reasonable method could be effectively argued since valuation is almost always a question of fact. Rev. Rul. 59-60, 1959-1 CUM. BULL. 237 § 3.01.

9. This plan assumes that the donor could take advantage of the specific exemption permitted by INT. REV. CODE OF 1954, § 2521 and the annual exclusion authorized by INT. REV. CODE OF 1954, § 2503(b).

10. See section IV(B)(2) *infra*.

11. INT. REV. CODE OF 1954, § 483; Treas. Reg. § 1.483-2(b)(3)(i) (1966).

12. See section VI(C) *infra* for a detailed discussion of the method of accomplishing this objective.

13. See section IV(A) *infra*.

those likely to appreciate—common stocks, convertible bonds and convertible preferred stocks. Of course, some non-appreciating securities could be transferred to the corporation for the purpose of selling them and re-investing in appreciating stocks and securities at a later date.¹⁴

Another consideration in this area is the type of income which is produced by the stocks or securities. As will be discussed more fully later,¹⁵ dividend income in the corporation will mitigate the double taxation effects of the corporate structure because of the 85% dividends received deduction,¹⁶ while interest income, which would be produced by convertible bonds, does not receive the benefit of this deduction. However, depending on the amount of debt in the capital structure, some of the interest income may be eliminated by payments of interest as an expense.

It should also be noted that since stocks and securities with a high potential for appreciation classically produce low income yields, the corporation, if its portfolio is composed mainly of such securities, will have a limited ability to pay fixed interest and preferred dividend obligations from its income. This fact may weigh heavily in determining the interest and dividend rates to be paid on the debt securities and preferred stock to be issued as well as in determining the total amount of capitalization needed to fund the payment of a fixed amount of cash each year.

E. *Effect of the Personal Holding Company Tax*

The second major objective of the plan is to prevent its income tax consequences from being any more burdensome than if the portfolio had been held by the owner-transferor. A number of problems in this area are created by the personal holding company provisions. The fact that these provisions will apply to the corporation¹⁷ makes it necessary as a practical matter to pay out all of the company's earnings as dividends.¹⁸ Normally the result of paying earnings out as dividends is a "double tax"—one at the corporate level on the income earned by the corporation, and one at the individual level on the dividends paid out to the shareholder.¹⁹

Since the tax at the corporate level may be as high as 48%²⁰ and the top individual rate is 70%²¹ the compound effect of these taxes could

14. It should be noted that this could be accomplished at a later date by means of a tax-free contribution to capital. See INT. REV. CODE OF 1954, §§ 118, 362(b) and the Regulations thereunder.

15. Section VI(C) *infra*.

16. INT. REV. CODE OF 1954, § 243.

17. See section V *infra*.

18. See section V, VI *infra*.

19. See BITTKER & EUSTICE, *supra* note 2.

20. INT. REV. CODE OF 1954, § 11.

21. INT. REV. CODE OF 1954, § 1.

make a plan of this nature totally impractical.²² Of course, it is unlikely that both the corporation and the shareholder will be in these brackets, but even at lower rates, the double taxation effect may be substantial.²³ One mitigating factor in some cases is the benefit of splitting income among several taxpayers (the corporation and its shareholders) to reduce the effect of the progressive tax, but this benefit will exist only to the extent the income may be spread among stockholders if, as is required in the instant case, the corporation must pay all of its earnings out as dividends. Another possible method of alleviating the double taxation effect is to pay out the corporate earnings to or for the benefit of the shareholders in the form of deductible expenses such as salaries, interest, contributions to qualified pension and profit sharing plans and payments pursuant to medical expense reimbursement plans.²⁴ To a limited degree such expenses may be justifiable under the plan in the instant case, but since such deductions must qualify as "ordinary and necessary" expenses for the production of income²⁵ the amount of expenses which would be allowable deductions are certainly limited, and would probably not be sufficient to completely eliminate the double taxation effect.

If the corporate income is composed to a great extent of dividends from domestic corporations,²⁶ § 243 allows an 85% dividends received deduction which would certainly alleviate the effect of double taxation considerably.²⁷ In addition, careful planning, through the use of the § 243

22. If both the corporation and the shareholder are in the top brackets, the overall tax rate would amount to 84.4%.

23. If the corporation is in the 22% bracket and the shareholder is in the 50% bracket, the overall tax rate will be 61%, or 11 percentage points higher than if the shareholder had received the income as an individual.

24. See section IX *infra*.

25. INT. REV. CODE OF 1954, §§ 162, 212 and the Regulations thereunder.

26. It is likely that the income of the corporation will be composed largely of dividends on stocks of domestic corporations since the plan, as discussed previously in section II(D) *supra*, is only applicable to a portfolio which has potential for substantial appreciation. It should be noted in this respect that although convertible bonds may appreciate substantially, the interest from such bonds does not receive the benefit of the dividends received deduction under INT. REV. CODE OF 1954, § 243. This fact may limit the effectiveness of the plan with regard to a portfolio composed largely of convertible bonds.

27. Assume, for example, that the corporate income is composed entirely of qualifying dividends, the shareholders are alternatively in the 30%, 50%, and 70% brackets, and the corporation is alternatively in the 22% and 48% brackets. In those cases, the overall tax brackets may be summarized by the following tabulation:

Shareholders' Tax Bracket	Corporate Tax Bracket	
	48%	22%
30%	35.04%	32.31%
50%	53.60%	51.65%
70%	72.16%	70.99%

When contrasted with the information set forth at note 26 *supra*, this table reflects that the double taxation effect is much less dramatic when the dividends received deduction is allowable. The table also demonstrates that the double taxation effect is reduced as the shareholders tax bracket is increased.

deduction, may, in certain circumstances, completely eliminate all income taxes at the corporate level and therefore the double taxation effect.²⁸

F. *Capital Gains on Sale of Corporate Assets*

Another major problem area is how to deal with capital gains as they arise. Proper portfolio management may require purchases and sales of securities at various intervals depending on the nature of the investments as well as many other factors. If the gain is not large or is mostly offset by losses, it may be absorbed at the corporate level by expenses. If the corporation has recognized a large gain there are two possible alternatives, neither of which is highly desirable. One is to distribute the gain as a current dividend. This, however, would cause the double taxation effect to come into play. The second alternative is to retain the gain in the corporation. This would be possible since such gains, if long-term, are not considered personal holding company income.²⁹ However, this is not a desirable alternative since such gains increase earnings and profits³⁰ and therefore taxable dividend potential for future years. Thus, under this alternative, the double taxation effect is merely deferred.

In addition, the building up of earnings and profits in this manner prevents the utilization of an important degree of flexibility. By keeping the earnings and profits of the corporation to a minimum, the bulk of distributions from the corporation, other than those representing current earnings and profits, will first be considered a tax-free return of capital, and then a capital gain from the sale or exchange of stock.³¹ This permits removal of assets from the corporation at any time with a minimum of tax cost.³²

G. *Use of Property Distributions*

1. LIQUIDITY AND SOLVING THE CAPITAL GAINS PROBLEM

Because it is probably possible to prevent recognition of gain at the corporate level³³ on such distributions, the capital gains problem could be solved by merely distributing the stocks to be sold to the shareholders and permitting them to make the sales.³⁴ The tax effect would be the same or more favorable than if the shareholders owned the stocks individually and sold them at a gain since only a capital gain, a tax-free basis recovery, or some combination thereof, would occur as a result of the distributions.

28. See section VI(C) *infra*.

29. INT. REV. CODE OF 1954, §§ 543, 545(b)(5). Also see section V *infra*.

30. See Rudick, "Dividends" and "Earnings or Profits" Under the Income Tax Law: Corporate Non-Liquidating Distributions, 89 U. PA. L. REV. 865 (1941); Albrecht, "Dividends" and "Earnings or Profits," 7 TAX L. REV. 157 (1952).

31. INT. REV. CODE OF 1954, § 301(c).

32. See section VII *infra*.

33. *Id.*

34. *Id.*

This procedure may also have the effect of splitting the capital gain among the various family members who are shareholders, if the stock is distributed ratably among them.

2. RETENTION OF CORPORATE ASSETS

If it is desired that the corporation retain the value relating to these assets and reinvest it in other stocks or securities, the proceeds from the sale could be recontributed to the corporation as a tax-free contribution of capital,³⁵ or if all requirements were met, a tax-free transfer to a controlled corporation.³⁶ In either case, the shareholders would receive an increase in the basis of their stock to the extent of the basis of any assets contributed,³⁷ and the basis of the contributed assets to the corporation would be the same as the basis of such assets in the hands of the transferring shareholders.³⁸ The increased shareholder basis could produce the additional advantage that future distributions of appreciated assets would, to a greater extent, be a tax-free recovery of basis.

The main problem with the recontribution of the proceeds to the corporation is the possible application of the step-transaction doctrine³⁹ which has been applied in a similar context to complete liquidations followed by reincorporation.⁴⁰ As applied to the instant situation, the distribution of the stock, its sale by the shareholders, and the recontribution of the proceeds could be considered mere steps in a plan, the overall effect of which is to have the corporation itself sell the stock. The recognition of gain by the corporation would, of course, defeat the purpose of the scheme. To avoid the possible application of the step transaction doctrine, the recontribution of the proceeds could be eliminated or delayed for a substantial period (possibly a year) after the sale.

3. RISK OF GAIN RECOGNITION AT THE CORPORATE LEVEL

Although the risk of a corporate capital gain is not great if the property distributions are properly planned, several additional alternative methods of handling the corporate capital gains problems will be considered. One possibility is to plan the realization of capital gains at the corporate level so that they may be eliminated by capital losses or other corporate expenses. Careful projections of potential gains in setting up the capital structure could make considerable excess interest deductions available to wipe out corporate gains since the amount of interest expense needed to completely eliminate dividend income is only 15% thereof.⁴¹

35. INT. REV. CODE OF 1954, § 118.

36. INT. REV. CODE OF 1954, § 351; section III *infra*.

37. Treas. Reg. § 1.118-1 (1956), INT. REV. CODE OF 1954, § 358.

38. INT. REV. CODE OF 1954, § 362(a).

39. See generally BITTKER & EUSTICE, *supra* note 2, ¶ 1.05, at 1-19 to 1-20.

40. *Id.* ¶ 11.05.

41. See section VI(C) *infra*.

For example, assume a portfolio consisting solely of common stocks in domestic corporations with a value of \$1,000,000 and an annual dividend yield thereon of approximately 3% or \$30,000. Assume further that the corporation is capitalized with \$500,000 of 20 year, 6% bonds, or an annual interest obligation of \$30,000. Ignoring other possible deductible expenses or capital losses, the corporation would have \$25,500 in deductions available to absorb possible capital gains.⁴²

The defect in this scheme is that earnings and profits would be increased by the capital gain and if this were distributed in its entirety the net effect would be to tax the shareholders on the gain at ordinary income rates. In the above example (assuming a gain of \$25,500 which is distributed), the shareholders would receive taxable dividends of \$25,500 in addition to the \$30,000 of interest. This result would not obtain, however, if the gains could be eliminated using losses.

Other possibilities are mentioned in section VII, *infra*, but none of them permits the same degree of flexibility as individual ownership of the portfolio as does the use of property distributions. This fact must be weighed by the planner in light of the circumstances of the particular situation in determining which method will be used to avoid the necessity of recognizing capital gains at the corporate level.

4. DISTRIBUTION OF EARNINGS AND PROFITS⁴³

Another possible use of property distributions is to distribute current earnings and profits. Since the stockholder-distributee would get a stepped up basis⁴⁴ and if capital gains at the corporate level upon distribution can be avoided⁴⁵ the immediate effect of this would be to avoid recognition of any capital gain. In addition, the undistributed personal holding company income would be reduced by the full fair market value of the property distributed, so that the personal holding company prob-

42. The amount of the excess deductions is computed as follows:

Dividend Income	\$ 30,000
Dividends Received Deduction (85% of Dividend Income)	(25,500)
Interest Expense	(30,000)
EXCESS OF DEDUCTIONS OVER INCOME	<u><u>\$(25,500)</u></u>

43. What are earnings and profits? No definition appears in the Internal Revenue Code of 1954 or the regulations thereunder. Their basic effect under INT. REV. CODE OF 1954, § 316(a) is to provide a ceiling for taxability of distributions from corporations to shareholders. Under that provision of the law, current and accumulated earnings and profits must be segregated in order to make the determination of whether a distribution is a taxable dividend.

Most computations of earnings and profits begin with taxable income and add artificial deductions such as the dividends received deduction, tax exempt income items, etc.; and subtract non-deductible expenses such as income taxes paid, etc.

For a full discussion of earnings and profits, see BITTKER & EUSTICE, *supra* note 2, ¶ 7.03; articles cited at note 30 *supra*.

44. INT. REV. CODE OF 1954, § 301(d).

45. See section VII *infra*.

lems will be eliminated by such distributions.⁴⁶ However, the earnings and profits of the corporation are only reduced to the extent of the basis of the distributed property.⁴⁷ For this reason, the gain inherent in such property will merely be deferred, and, assuming that the remaining earnings and profits are later distributed to the shareholders, the gain will be recognized in the form of dividend income to the shareholders. In addition, the earnings and profits are not minimized when current earnings and profits are distributed in this manner. Thus, it would seem that paying dividends in kind to distribute current earnings is not desirable.

H. *Liquidation of the Corporation*

If, as recommended, the earnings and profits are kept low, the corporation may, if desired, be effectively liquidated on an installment basis over a period of several years by merely making a gradual distribution of the assets of the corporation to the shareholders. As discussed above, this would merely produce a tax-free recovery of basis or a capital gain to the shareholder. Even if the earnings and profits are not kept low, certain types of redemptions may be effected so that the stockholders whose shares are being redeemed will have a capital gain and there will be no tax consequences at the corporate level.⁴⁸

I. *Use of Fringe Benefit Plans*

In addition, the corporate form of operation may permit the use of fringe benefit plans, such as qualified pension and profit sharing plans and medical expense reimbursement plans, which can have highly advantageous tax consequences.⁴⁹

III. QUALIFICATION OF THE TRANSFER UNDER § 351

A. *General Implications of a § 351 Transaction*

Internal Revenue Code § 351 provides in pertinent part that a transfer of property by one or more persons to a corporation other than an "investment company" will be tax-free if the transfer is solely in exchange for stock or securities and the transferors are in control of the corporation immediately after the transfer. If the assets to be transferred to the corporation have market values in excess of their bases, it will be essential to qualify the transfer under this section to avoid the recognition of gain resulting from a taxable exchange.⁵⁰

46. See section VI(A)(2) *infra*.

47. INT. REV. CODE OF 1954, § 312(a)(3).

48. See section VIII *infra*, for a full discussion of liquidations and other methods of removing property from the corporation.

49. See section IX *infra*, for a full discussion of the use of fringe benefit plans.

50. INT. REV. CODE OF 1954, § 1001 provides the general rules for realization and recognition of such gain.

As in most "tax-free" transactions, the tax effect of the transfer is merely deferred by virtue of the provisions relating to the basis of the property transferred. The basis of the stock or securities received by the transferors in a qualifying transaction in which no gain or loss is recognized is the same as that of the property transferred to the corporation,⁵¹ and the basis of the transferred property in the hands of the corporation is the same as it was in the hands of the transferor.⁵²

In determining the holding period for the stock and securities received by the transferor and the property received by the corporation, the transferor's holding period for the transferred assets may normally be "tacked."⁵³ To assure qualification of the transfer of the portfolio under § 351, some of the requirements should be considered in detail.

B. *The Transfer Must Be in Exchange for Stock or Securities*

Since the preferred and common stock to be issued are clearly "stock or securities" within the plain meaning of the statute, there is no problem in qualifying the transaction under § 351 by virtue of the issuance of these instruments. Some difficulty, however, may be encountered in determining whether the debt proposed to be issued⁵⁴ may be classified as securities.

Apparently the time to maturity has been the most important factor in determining whether debt instruments are to be classified as securities. For example, in one case,⁵⁵ ten year notes were declared securities, but in another case,⁵⁶ two year notes were held not to be securities. After surveying the cases on the issue, one esteemed writer has stated that "[n]otes with a five-year term or less rarely seem able to qualify as 'securities', while a term of ten years or more ordinarily is sufficient to bring them within the statute."⁵⁷ Thus, it seems clear that the debt obligations used in the plan should have at least a ten year term.

C. *Continuity of Interest Doctrine*

Although the term of the debt instrument is probably the key factor in determining whether a security exists within the meaning of § 351, it is clear that

the controlling consideration is an over-all evaluation of the origin and nature of the debt, the degree of participation and

51. INT. REV. CODE OF 1954, § 358(a)(1).

52. INT. REV. CODE OF 1954, § 362(a).

53. INT. REV. CODE OF 1954, § 1223(1) (as to the transferor), § 1223(2) (as to the corporation).

54. See section II(B) *supra*.

55. George A. Nye, 50 T.C. 203 (1968).

56. Lloyd-Smith v. Commissioner, 116 F.2d 642 (2d Cir.), *cert. denied*, 313 U.S. 588 (1941).

57. BITTKER & EUSTICE, *supra* note 2, ¶ 3.04 at 3-15.

continuing interest in the business and the extent of the proprietary interest (arising because of the issuance of an obligation), the purpose of the advances, and other like considerations.⁵⁸

In *Camp Wolters Enterprises, Inc. v. Commissioner*,⁵⁹ the notes in question were payable within five to nine years, but soon after their issuance they were subordinated to large bank loans so that the "note-holders were assuming a substantial risk of [the taxpayer's] enterprise" ⁶⁰ Accordingly, the court found that the notes constituted securities within the meaning of § 112(b)(5) of the Internal Revenue Code of 1939 (the forerunner of § 351).⁶¹

The facts of the cases discussed in the text and footnotes above do not apply directly to the instant situation, but the "overall evaluation" test may raise questions as to the applicability of the "continuity of interest" doctrine. This doctrine has been developed largely in connection with the reorganization provisions⁶² and requires the transferor to retain "a substantial stake in the enterprise."⁶³ If applicable, a transaction would not qualify under § 351 unless the transferor retained a continuing interest in the enterprise transferred to the corporation.

It is not clear whether the scope of the doctrine is broad enough to encompass § 351, but the language of some cases, although arguably dicta, is strong enough to require the prudent planner of a § 351 transaction to take into account the possibility of its application. For example, one decision stated:

We see no justification for supposing that the word "securities" had different meanings when used in the reorganization subdivisions and in those relating to transfers. Continuity of interest if required to satisfy the term as used in subdivisions 112(b) (3) and (4) [the reorganization provisions] ought to be required for 112 (b)(5) [the forerunner of § 351].⁶⁴

Under the plan in the instant situation, it seems clear that the doctrine would be satisfied. Where the transferor received only cash and short term notes, there was no continuity of interest,⁶⁵ but where cash plus an entire issue of preferred stock was received, the owner of

58. *Camp Wolters Enterprises, Inc. v. Commissioner*, 230 F.2d 555, 557 n.2 (5th Cir.), cert. denied, 352 U.S. 826 (1956) (emphasis deleted) (quoting the taxpayer's brief and approving of the test set forth therein).

59. *Id.*

60. *Id.* at 560, quoting *Camp Wolters Enterprises, Inc.*, 22 T.C. 737 (1954).

61. Similarly, in two other cases, *Aqualane Shores, Inc. v. Commissioner*, 269 F.2d 116 (5th Cir. 1959) and *Sun Properties, Inc. v. United States*, 220 F.2d 171 (5th Cir. 1955), it was determined that debt instruments in thinly capitalized corporations were securities on the basis that the holders of such obligations had assumed some of the risks of the enterprise.

62. See INT. REV. CODE OF 1954, § 368.

63. See, e.g., *LeTulle v. Scofield*, 308 U.S. 415 (1940).

64. *Lloyd-Smith v. Commissioner*, 116 F.2d 642, 644 (2d Cir.), cert. denied, 313 U.S. 588 (1941).

65. *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933).

such stock, although non-voting, was held to have acquired a substantial interest in the affairs of the corporation and therefore the doctrine was satisfied.⁶⁶

Since this plan contemplates the issuance of debt and voting preferred stock to the owner-transferor, there would clearly be sufficient continuity of interest to qualify under § 351. However, care should be taken if the basic scheme is modified in such a way that any transferor receives only debt securities because, in applying the doctrine, the terms of the obligations are not material, and the transfer by him in these circumstances may constitute a taxable exchange for lack of a continuity of interest.⁶⁷

D. *The Control Requirement*

In order for a transaction to come within the ambit of § 351, the transferors must collectively "control" the corporation immediately after the transfer. Reference is made in § 351 to § 368(c) for the definition of control. That provision requires ownership of at least 80% of the total voting power and 80% of the total number of shares of all other classes of stock.

It is clear that the government construes that section as making ownership by the transferors of at least 80% of the total number of shares of *each class* of stock mandatory.⁶⁸ Thus, if the transaction is structured so that the owner-transferor's children, for example, receive all of the non-voting common stock and do not transfer any property to the corporation, § 351 will not apply.

Several solutions are possible here. The persons receiving the common stock could become transferors by contributing some of their own property to the corporation in exchange for the stock. Making the common stockholders transferors may also have other advantages in connection with the possible application of § 2036(a) and § 2038.⁶⁹

66. *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935).

67. *LeTulle v. Scofield*, 308 U.S. 415, 420 (1940).

68. Rev. Rul. 59-259, 1959-2 CUM. BULL. 115.

69. See section XI *infra*. Since the amount to be transferred by the common stockholders may be relatively small it should be noted that the de minimus rule stated in Treas. Reg. § 1.351-1(a)(1)(ii) (1967), disqualifying as transferors persons who transfer relatively small amounts of property to the corporation, does not pose any problems in this situation since it only applies where the transferor already owns stock or securities in the transferee corporation, or where he is receiving the stock or securities partially in exchange for services rendered by him to the corporation.

Another approach would be to have the owner-transferor take all of the stock in exchange for his property and subsequently transfer the common stock to his children. This procedure may, however, present a problem with the requirement under § 351 that the transferors must control the corporation immediately after the transfer. See section III(E) *infra*.

E. The "Immediately After" Requirement

In a commercial setting, there are decisions and rulings holding that mere momentary control is not sufficient for qualification under § 351.⁷⁰ Two leading cases in this area⁷¹ have involved situations where the stock, soon after issuance, was to be resold to the public.

The basic test set out in these cases is that if the initial issuance and subsequent disposal are so interdependent that one would be fruitless without the other, the immediately after requirement is not satisfied.⁷² But where the initial issuance has a significant purpose unrelated to the subsequent disposition, the transaction may qualify.⁷³

If this test were applied to the plan, the owner-transferor taking all the stock and then transferring it to his children, it would be a close question as to whether the transaction could qualify. Although a strong argument could probably be made in favor of qualification, the uncertainty of the situation is anything but ideal—particularly at the planning stage. Of course, the taxpayer's position could probably be strengthened if the owner-transferor held all the stock for a substantial period before transferring it, but in the interval the value of the common stock may increase causing adverse gift tax consequences or making a transfer for adequate consideration infeasible.

Although a noncommercial setting has not been expressly distinguished by the courts, at least one case may present some authority for a valid distinction.⁷⁴ *Wilgard Realty Co. v. Commissioner*⁷⁵ stated in effect that although the transferor had made up his mind to give away some of the stock after the transfer, he was under no obligation to do so. For that reason, the court found that the transferor did in fact have control immediately after the exchange.

Certainly a cogent argument can be made for applying the *Wilgard* case to the plan being analyzed here. The case could probably even be squared with the rationale of the *Manhattan Building Co.*⁷⁶ and *American Bantam Car Co.*⁷⁷ cases. However, it might also be asserted, particularly in light of the early date of the decision, that the *Wilgard* decision is similar to the early cases⁷⁸ which, in light of later decisions,⁷⁹ are no

70. See, e.g., Rev. Rul. 70-140, 1970-1 CUM. BULL. 73.

71. *Manhattan Bldg. Co.*, 27 T.C. 1032 (1957), *acquiesced in* 1957-2 CUM. BULL. 5; *American Bantam Car Co.*, 11 T.C. 397 (1948), *aff'd* 177 F.2d 513 (3d Cir. 1949).

72. *Manhattan Bldg. Co.*, 27 T.C. 1032, 1042 (1957), *acquiesced in* 1957-2 CUM. BULL. 5.

73. *American Bantam Car Co.*, 11 T.C. 397 (1948), *aff'd*, 177 F.2d 513 (3d Cir. 1949).

74. *Wilgard Realty Co. v. Commissioner*, 127 F.2d 514 (2d Cir.), *cert. denied*, 317 U.S. 655 (1942) [hereinafter referred to as *Wilgard*].

75. *Id.*

76. 27 T.C. 1032 (1957).

77. 11 T.C. 397 (1948).

78. See, e.g., *Portland Oil Co. v. Commissioner*, 109 F.2d 479 (1st Cir.), *cert. denied*, 310 U.S. 650 (1940).

79. See notes 71-78 *supra*, and accompanying text.

longer considered good law.⁸⁰ This fact may cause the cautious planner to use one of the other techniques suggested above to satisfy the control requirement.

F. *Value of Stock or Securities Received by the Transferors*

The value of the stock or securities received by each transferor need not be equivalent to the property transferred by him to the corporation in order to qualify under § 351.⁸¹ However, where such values are not equivalent, a gift may be deemed to have been made⁸² to the extent of the disparity between the values. The application of this rule to the plan seems obvious. Accordingly, the planning of the transaction should take into account the possible gift tax consequences which may result.⁸³

G. *Transfer to an "Investment Company"*

Section 351 does not apply to transfers to "investment companies" after June 30, 1967.⁸⁴ A transfer to an investment company is deemed to have occurred where diversification in the transferor's interests results directly or indirectly and 80% of the value of all the transferee corporation's assets other than cash and non-convertible debt are held for investment and are readily marketable stocks or securities (*i.e.*, traded on an exchange or quoted regularly in an over the counter market), or interests in regulated investment companies or real estate investment trusts.⁸⁵

The transferee corporation under this plan would almost certainly satisfy the second requirement, but through careful planning the diversification requirement may be avoided. The regulations⁸⁶ state that diversification occurs where two or more persons transfer nonidentical assets to the corporation. However, if there are one or more transfers of nonidentical assets which, when aggregated, constitute an insignificant portion of the value of all assets transferred, they will be disregarded in determining whether diversification occurred. The examples in the regulations⁸⁷ set outside limits on the definition of an insignificant portion by illustrating that approximately 1 percent comes within the definition, but 50 percent does not. It would certainly seem that 3 percent to 4 percent would still be considered insignificant. Thus, if the eventual common stockholders actually transfer property to the corporation, its

80. *But see* BITTKER & EUSTICE, *supra* note 2, ¶ 3.10 at 3-37.

81. Treas. Reg. § 1.351-1(b)(1) (1955).

82. *Id.*; INT. REV. CODE OF 1954, § 351(e)(3).

83. *See* INT. REV. CODE OF 1954, § 2501 *et seq.* The valuation problems relating to such a gift are discussed at section X *infra*.

84. Treas. Reg. § 1.351-1(c)(1) (1967).

85. Treas. Reg. § 1.351-1(c) (1967).

86. Treas. Reg. § 1.351-1(c)(5) (1967).

87. Treas. Reg. § 1.351-1(c)(6) (1967).

aggregate value should be low enough to stay safely within the insignificant portion rule.

The diversification problem could also be avoided by having the common shareholders transfer assets identical to those transferred by the owner-transferor. This would seem to require that owner-transferor and the common stockholders transfer exactly the same stocks and bonds in the same proportions. Although this may involve some practical difficulty, if it is done there will be no risk of diversification.

Another possible means of avoiding the investment company problem is to have the owner-transferor take *all* the stock and securities and then have him transfer the common stock to the intended holders. The regulations, although they are somewhat ambiguous, seem to pre-empt the use of this type of scheme by stating: "If a transfer is part of a plan to achieve diversification without recognition of gain, . . . the original transfer will be treated as resulting in diversification."⁸⁸ In addition, this type of structuring for the transaction may present problems in relation to the immediately after requirement.⁸⁹

It should be emphasized that if large amounts of appreciated securities are transferred to the corporation, great care must be taken to prevent the occurrence of diversification, since, if present, the entire transaction will fail to qualify under § 351 and gain or loss will be recognized on the transfer by *all parties*.

H. *Basis after Qualifying the § 351 Transfer and Possible Planning Devices Related Thereto*

As stated previously,⁹⁰ the basis for the stock and securities received by the shareholders in a qualifying exchange is the same as the aggregate basis of the property transferred to the corporation,⁹¹ and the basis of the transferred property in the hands of the corporation is the same as it was in the transferor's hands.⁹² Under the regulations,⁹³ the basis of the stock and securities received in the exchange must be allocated in proportion to their various fair market values.

Since the owner-transferor will be contributing most of the corporate assets, the stock and securities he receives will have the greatest fair market value and therefore the highest basis. The importance of this fact is that, to the extent of the basis of the stock received, a shareholder may remove appreciated assets from the corporation tax-free (assuming

88. Treas. Reg. § 1.351-1(c)(5) (1967).

89. See section III(D) *supra*.

90. Section III(A) *supra*.

91. INT. REV. CODE OF 1954, § 358.

92. INT. REV. CODE OF 1954, § 361.

93. Treas. Reg. § 1.358-2(b)(2) (1955).

earnings and profits have been used up)⁹⁴ and receive a stepped-up basis (*i.e.*, equal to fair market value) for them at that time.⁹⁵

There are several advantages which may result from receipt of a higher basis equalling fair market value. The property may be sold by the distributee after the distribution and the gain will be lower since the amount realized will be closer to the basis of the property sold.⁹⁶ Although the basis of the remaining stock held is reduced to the extent of the distribution⁹⁷ any capital gains on sales of corporate assets are deferred until the basis of the stock is used up. In addition, since the owner-transferor will probably be the first of the shareholders to die, the gain potential in his stock may be completely eliminated if he still holds it at death because it will receive a stepped-up basis at that time.⁹⁸ In this way, gain recognition may be partially eliminated.⁹⁹

Furthermore, the total tax basis of the family unit could be maximized if the owner-transferor made lifetime gifts of stock (with minimal gift tax cost) thus distributed to him. For example, assume that the stock of the owner-transferor has a basis of \$100,000 and a fair market value of \$1,000,000. Assume further that \$100,000 worth of corporate assets are distributed to him as a dividend at a time when there are no earnings and profits (current or accumulated). The assets distributed are then given away,¹⁰⁰ and the donees receive a substituted basis of \$100,000.¹⁰¹ The owner-transferor then dies when his stock is worth \$1,000,000 which has a basis of zero. That stock receives a basis under § 1014(a) of \$1,000,000 and the donees have had the benefit of an additional \$100,000 of basis at minimal tax cost.¹⁰²

It should be noted that if securities which have depreciated are distributed in the manner described above, the effect will be to defer tax

94. See section II(F) *supra*.

95. See section VI(B) *infra*.

96. INT. REV. CODE OF 1954, § 1001; *but see* section VII *infra*, for a discussion of the possibility that gain may be recognized to the distributing corporation as a result of such a distribution if it is closely followed by a sale or exchange of the distributed property.

97. INT. REV. CODE OF 1954, § 301(c)(2).

98. INT. REV. CODE OF 1954, § 1014(a).

99. *But, see* section VII *infra*, in relation to the problems which arise as a result of sales or exchanges of distributed property.

100. It is assumed that the gift thus made is not in contemplation of death under the terms of INT. REV. CODE OF 1954, § 2035.

101. INT. REV. CODE OF 1954, § 1015. It should be noted that the gift tax paid in connection with the transfer is also added to basis, but the total basis in the hands of the donee may not exceed the fair market value of the subject property at the time the gift is made. With this latter rule in mind, the gift should be planned in such a way as to maximize the basis increase resulting from the gift tax paid.

102. The statement regarding minimal gift tax cost assumes that the owner-transferor is married and therefore able to use the gift splitting provisions of INT. REV. CODE OF 1954, § 2513, and that neither the owner-transferor nor his spouse has used any part of the specific exemption provided for in INT. REV. CODE OF 1954, § 2521.

This will permit the owner-transferor to make nontaxable gifts of \$60,000 plus additional gifts up to \$6,000 per donee. INT. REV. CODE OF 1954, § 2503. Nevertheless, a small gift tax may result if a gift of \$100,000 is made.

losses which is certainly not desirable. The maximization of basis, however, could be accomplished with such assets.

IV. USE OF DEBT CAPITALIZATION

A. *Benefits to be Derived from the Use of Debt*

As stated previously, the corporation would be capitalized through a combination of debt which would qualify as securities within the meaning of § 351, preferred stock and common stock. The use of debt capitalization deserves special attention. Before discussing the means of preventing instruments which are nominally debt from being classed as equity for tax purposes, some of the economic and tax ramifications of the debt versus equity question should be considered in light of the particular circumstances of the instant situation.

One effect of the debt is that the interest payable thereon is deductible under § 162 or § 212. This fact will operate to mitigate or eliminate¹⁰³ the double taxation effect,¹⁰⁴ whereas dividends paid on equity instruments are nondeductible and tend to produce double taxation.

However, the securities transferred to the corporation are likely to have a low cash yield as common stocks in public companies frequently do, and if the amount of the debt and the interest rate thereon are too high, there may not be sufficient cash in the form of dividend and interest income to fund the interest obligation. Even more importantly, a high interest rate on a large amount of debt securities may operate in combination with the dividends from the preferred stock to give the owner-transferor a disproportionate amount of taxable income.

If the interest paid on the debt were more than the total income of the corporation, there could be an actual increase in aggregate income of the corporation and the shareholders. The planner of the transaction should consider this possibility, and carefully attempt to avoid this effect by determining the interest rate and the amount of debt to be issued accordingly. In addition, it should be noted that distribution of property in satisfaction of an interest obligation is a taxable transaction,¹⁰⁵ while no gain or loss is recognized on distributions of property with respect to stock.¹⁰⁶

There are other frequently cited advantages of using debt as opposed to equity such as removal of corporate assets through debt repayment

103. See section VI(C) *infra*.

104. Section II(E) *supra*.

105. In light of cases such as *Helvering v. Hammel*, 311 U.S. 504 (1941) and *Electro-Chemical Engraving Co. v. Commissioner*, 311 U.S. 513 (1941), this type of transaction would certainly seem to constitute a sale or other disposition as contemplated by INT. REV. CODE OF 1954, § 1001. See section VII(A), *infra*, and cases cited therein for a somewhat analogous situation.

106. INT. REV. CODE OF 1954, § 311. See section VII *infra*, and note the effect on earnings and profits discussed in section II(G)(4) *supra*, and section VI(A) *infra*.

which produces no income to the creditor,¹⁰⁷ but this may also be accomplished in the instant case by distributions with respect to stock since earnings and profits are to be kept low. Similarly, the other advantages have limited or no application here. The deductibility of the interest, however, is a considerable benefit and may prove to be an essential element for the success of the plan since it may be used to mitigate or eliminate the double taxation effect.¹⁰⁸

B. *Problems in Having the Instruments Classed as Debt*

Given the advantage of using some debt capitalization in this situation, there are certain problems which may be encountered in having it treated as such for tax purposes. Frequently, the Internal Revenue Service will attempt to have the alleged debt treated as equity if that is its true nature.¹⁰⁹

The issue of whether the instrument is debt or equity is a question of fact, and for that reason no simple test may be relied upon in making the determination. One case,¹¹⁰ stated:

[I]n the final analysis each case must rest and be decided upon its own unique factual flavor, dissimilar from all others, for the intention to create a debt is a compound of many diverse external elements pointing in the end to what is essentially a subjective conclusion.¹¹¹

This type of approach is necessarily perplexing to the planner, but an analysis of the numerous cases on the subject shows that a number of factors have been considered.¹¹² Some of them will be considered in the discussion that follows.

1. PROPORTIONAL HOLDINGS OF DEBT AND STOCK

Where the same persons hold debt and stock in similar proportions, the courts will scrutinize the debt capitalization carefully.¹¹³ Particularly relevant here is the fact that technical disproportion may be disregarded in cases where the family as a unit has proportional holdings.¹¹⁴ But the Court of Claims in *Liflans Corp. v. United States*¹¹⁵ stated:

107. Satisfaction of debt with property, however, will constitute a taxable event. See note 105 *supra*, and cases cited therein.

108. See section VI(C) *infra*.

109. See, e.g., *Jack Daniel Distillery v. United States*, 379 F.2d 569 (Ct. Cl. 1967).

110. *American Processing and Sales Co. v. United States*, 371 F.2d 842 (Ct. Cl. 1967).

111. *Id.* at 848.

112. One writer sets out 24 different criteria which have been considered by various courts in determining whether certain capitalization was debt or equity. 4A J. MERTENS, JR., *LAW OF FEDERAL INCOME TAXATION* § 26.10(c), at 72-80 (1967).

113. *Gilbert v. Commissioner*, 248 F.2d 399 (2d Cir. 1957).

114. *Liflans Corp. v. United States*, 390 F.2d 965 (Ct. Cl. 1968). See also *P.M. Finance Corp. v. Commissioner*, 302 F.2d 786 (3d Cir. 1962); *Wilbur Security Co. v. Commissioner*, 279 F.2d 657 (9th Cir. 1960).

115. 390 F.2d 965 (Ct. Cl. 1968).

[T]his factor alone is not controlling, and must be weighed against all the factors in the case. . . . It is true, as defendant contends, that proportionality has been an important factor in many cases holding that instruments denominated debt actually represented equity. But in those cases . . . many other factors also militated against a debt characterization.¹¹⁶

2. THIN CAPITALIZATION

Where the corporate capital structure has a high proportion of debt as compared to equity, the courts may take this into account as an indication that holders of the debt are taking risks similar to those taken by the shareholders. However, all circumstances must be considered to determine what ratio is excessive, and in the final analysis the debt to equity ratio is only one factor to be considered.¹¹⁷ One writer has suggested that if the ratio is less than 3:1 that the corporation will not be regarded as thinly capitalized.¹¹⁸ It should also be noted that in computing the ratio, fair market values of assets, including goodwill, are used.¹¹⁹

3. SUBORDINATION OF DEBT

Where the debt held by a shareholder is subordinated to other corporate obligations it may be considered similar in terms of risk, etc. to equity,¹²⁰ but again this may be outweighed by other factors.

4. OTHER FACTORS

Following are several other factors which should be considered in planning the transaction:

(1) Intent of the parties as reflected by the surrounding facts and circumstances including the terms of the instrument.¹²¹

(2) Substantial economic reality of the transaction. This includes such considerations as whether a loan on similar terms could be obtained from an outside lender.¹²²

(3) Section 385, recently added to the income tax law, also sets out several factors to be considered, and authorizes the Treasury Depart-

116. *Id.* at 971, referring to *Affiliated Research, Inc. v. United States*, 351 F.2d 646 (Ct. Cl. 1965) (citations omitted).

117. See, e.g., *Gloucester Ice and Cold Storage Co. v. Commissioner*, 298 F.2d 183 (1st Cir. 1962); *Rowan v. United States*, 219 F.2d 51 (5th Cir. 1955).

118. BITTKER & EUSTICE, *supra* note 2, ¶ 4.04 at 4-13.

119. *Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2d Cir. 1956).

120. See, e.g., *Liflans Corp. v. United States*, 390 F.2d 965 (Ct. Cl. 1968); *Jack Daniel Distillery v. United States*, 379 F.2d 569 (Ct. Cl. 1967).

121. *American Processing & Sales Co. v. United States*, 371 F.2d 842, 848 (Ct. Cl. 1967); *Liflans Corp. v. United States*, 390 F.2d 965 (Ct. Cl. 1968).

122. *American Processing & Sales Co. v. United States*, 371 F.2d 842, 848 (Ct. Cl. 1967); *Liflans Corp. v. United States*, 390 F.2d 965 (Ct. Cl. 1968).

ment to promulgate regulations to effectuate that provision. The statute is very general and no regulations have been proposed at the time of this writing.

C. *Recommendations Relating to Debt Capital in This Plan*

As already discussed, there are no sure answers in this area, but the careful planner will attempt to get as many as possible of the foregoing factors working in his favor, both at the inception of the plan and during its operation, through proper draftsmanship and continuing advice to his client. If the family solidarity rule¹²³ applies, it would probably not be possible in this plan to achieve anything other than "technical disproportion" between stock and debt holdings. However, the other factors could be satisfied by having a low debt to equity ratio, using all the formalities and terms that would be required by parties dealing on an arms-length basis, attempting to avoid subordination, and having the corporation make principal and interest payments strictly in accordance with the terms of the instrument.

V. PERSONAL HOLDING COMPANY PROVISIONS—BASIC CODE STRUCTURE AND ITS APPLICATION TO AN INCORPORATED PORTFOLIO

Section 542 defines a personal holding company as a corporation, 60 percent of whose adjusted ordinary gross income¹²⁴ is personal holding company income,¹²⁵ and more than 50 percent of the stock of which was owned at any time during the last half of the taxable year by 5 or fewer individuals.

The disadvantage of being classed as a personal holding company is that, in addition to any income taxes, a personal holding company tax of 70 percent of the "undistributed personal holding company income" is imposed on the corporation.¹²⁶ In effect, these sections require a personal holding company to distribute all its personal holding company income to its shareholders as dividends in order to avoid the imposition of the prohibitive tax discussed above. More technically, the base for the personal holding company tax (undistributed personal holding company income) is reduced by a "dividends paid deduction."¹²⁷

It is certain that an incorporated portfolio as contemplated in this plan would be a personal holding company since all of its adjusted ordinary gross income would normally be interest and dividends which are classified as personal holding company income by § 543(a)(1), and because it would be highly improbable, taking into account the attribution

123. Section IV(B)(1) *supra*.

124. INT. REV. CODE OF 1954, § 543(b)(2).

125. INT. REV. CODE OF 1954, § 543.

126. INT. REV. CODE OF 1954, § 541. Undistributed personal holding company income is defined in INT. REV. CODE OF 1954, § 545.

127. INT. REV. CODE OF 1954, § 561 *et seq.*

rules of § 544, that the stock ownership test of § 543(a)(2) would not be satisfied. In order to prevent that test from applying there must be at least 10 unrelated shareholders. That would be most unlikely under this plan.

Since the corporation will be a personal holding company, dividends must be paid to the extent necessary to eliminate all undistributed personal holding company income.¹²⁸ In somewhat simplified form, the amount of the required distribution would be computed as follows:

Taxable Income

Less: Income Taxes

Long Term Capital Gain over Short Term Capital Loss

Net of Income Tax related thereto

Add: § 243 Dividends Received Deduction¹²⁹

It should be noted, as suggested by the foregoing formula, that the penalty tax is not imposed on long term gains from securities sales,¹³⁰ but, as recommended previously,¹³¹ realization of such gains should be avoided at the corporate level.

Two additional rules should be mentioned. First, the accumulated earnings tax¹³² does not apply to a personal holding company,¹³³ and therefore no problems with that tax will be encountered in this situation. Second, to the extent of undistributed personal holding company income (determined without reduction for distributions) distributions are deemed taxable dividends even though earnings and profits are less than this amount.¹³⁴ This provision should have little or no effect in the instant situation since earnings and profits will, as a practical matter, be equal to or greater than the undistributed personal holding company income as adjusted.¹³⁵

VI. VARIOUS TAX EFFECTS OF THE PRACTICAL NECESSITY OF DISTRIBUTING THE CORPORATE EARNINGS EACH YEAR TO AVOID THE PERSONAL HOLDING COMPANY TAX

A. *At the Corporate Level*

1. PAYMENT OF DIVIDENDS IN CASH

Since the Code does not permit a corporation to deduct cash dividends for income tax purposes there would be no income tax effect at the corporate level from paying cash dividends. However, corporate

128. INT. REV. CODE OF 1954, § 561 *et seq.*

129. *See* INT. REV. CODE OF 1954, § 545.

130. INT. REV. CODE OF 1954, § 545(b)(5).

131. Section II(F) *supra*.

132. INT. REV. CODE OF 1954, § 531 *et seq.*

133. INT. REV. CODE OF 1954, § 532(b)(1).

134. INT. REV. CODE OF 1954, § 316(b).

135. *See* the discussion of earnings and profits in section II(G)(4) *supra*.

earnings and profits would be reduced by the amount of the distribution.¹³⁶

2. PAYMENT OF DIVIDENDS IN KIND

The same rules regarding deductibility would apply as with cash dividends, but various other questions arise:

- (1) Will recognition of gain or loss result from the distribution?¹³⁷
- (2) What is the effect of property distributions on earnings and profits?¹³⁸
- (3) What is the effect of a property distribution on the undistributed personal holding company income?¹³⁹

As discussed above, reduction of the undistributed personal holding company income to zero is necessary to avoid the personal holding company tax. The amount of the dividends paid deduction is determined by § 561 and § 562. Among other things, the deduction includes dividends paid during the year. Section 316, referred to in § 561 and § 562, defines a dividend as a distribution of property by a corporation to its shareholders, but one limited to the current and accumulated earnings and profits of the distributing corporation, and, in the case of a personal holding company, to the extent of the undistributed personal holding company income if greater than the current and accumulated earnings and profits. In addition, § 316(a) defines distribution by reference to § 301. Section 301(b)(1)(A) states that the amount of a distribution includes the fair market value of any property received by the shareholder (assuming it otherwise comes within the definition of a distribution).

Under this analysis, it would seem that the dividends paid deduction under § 561 and § 562 would include any dividends in kind paid during the taxable year to the extent of the fair market value of such property distributions. There is a recent case which so held through the use of similar reasoning.¹⁴⁰

B. *At the Shareholder Level*

As stated previously,¹⁴¹ a distribution with respect to corporate stock as defined in § 301 is taxed to the distributee-shareholder as a dividend

136. INT. REV. CODE OF 1954, § 312(a)(1).

137. See section VII *infra*.

138. See section II(G)(4) *supra*.

139. See section V *infra*, for a basic discussion of the personal holding company provisions including undistributed personal holding company income.

140. *H. Wetter Mfg. Co. v. United States*, 458 F.2d 1033 (6th Cir. 1972). See also 2 RABKIN & JOHNSON, *FEDERAL INCOME, GIFT, AND ESTATE TAXATION* § 17.11(3) (1971) (agreeing that the dividends paid deduction is measured by the amount of the "dividend" to the shareholder). But see Treas. Reg. § 1.562-1(a) (1958) stating that the amount of the deduction for dividends paid in the case of a property distribution is the basis of the property distributed. This appears contrary to the statutory language discussed in the text, but an analogy to INT. REV. CODE OF 1954, § 312(a)(3) might be argued in favor of the validity of the regulation.

141. Section II(G)(3) *supra*.

pursuant to § 301(c)(1) to the extent of the shareholder's pro rata share of corporate earnings and profits, and, if a personal holding company, to the extent that undistributed personal holding company income (not reduced by distributions to which § 316(b) applies) exceeds corporate earnings and profits.¹⁴²

To the extent the distribution is not a dividend, it is first deemed a tax-free return of the cost basis in the stock to the extent of such basis, and any excess is deemed a gain on the sale or exchange of the stock.¹⁴³ Where there is a distribution in kind, an individual shareholder-distributee's basis for the distributed property is fair market value.¹⁴⁴

C. *Taxation of the Recurring Income Produced by the Portfolio*

Taxation of income from the portfolio at the corporate level is substantially sheltered by the dividends received deduction allowed by § 243(a). This deduction amounts to 85% of the dividends received from domestic corporations. Thus, only 15% of such dividends are subject to the corporate income tax. However, the deduction is limited by § 246(b)(1) to 85% of the corporate taxable income before the § 243 deduction, *unless* the corporation has a net operating loss as defined in § 172.¹⁴⁵

If the portfolio were managed with these rules in mind, highly favorable tax treatment could result. Assuming the corporation can be capitalized with substantial debt,¹⁴⁶ there would be a considerable deductible interest expense to be paid each year. Also, assuming that the bulk of the portfolio consisted of stocks whose dividends would qualify for the 85% deduction (which is likely),¹⁴⁷ a net operating loss would probably result in any year in which there were no extraordinary items such as capital gains.¹⁴⁸ If there were such a loss, there would be *no* tax payable at the corporate level, thereby completely eliminating the double taxation effect.

VII. POSSIBLE RECOGNITION OF GAIN OR LOSS AT THE CORPORATE LEVEL AS A RESULT OF PROPERTY DISTRIBUTIONS

The general rule that no gain or loss is recognized by a corporation on a distribution of property with respect to its stock is clearly set out in § 311, and none of the exceptions stated therein would apply in this case. There are, however, several situations where the corporation may be required to recognize gain despite § 311.

142. INT. REV. CODE OF 1954, § 316.

143. INT. REV. CODE OF 1954, § 301(c)(2), (3).

144. INT. REV. CODE OF 1954, § 301(d).

145. INT. REV. CODE OF 1954, § 246(b)(2).

146. See section IV *supra*.

147. See section II(D) *supra*.

148. INT. REV. CODE OF 1954, § 172(d)(6) shows that the 85% deduction is allowable in computing the net operating loss.

A. *Satisfaction of a Pre-Existing Obligation to Pay a Dividend*

First, the resolution declaring the dividend should initially be framed in terms of a property distribution in order to avoid any possible argument that a pre-existing debt of a specific monetary amount is being satisfied by a distribution of appreciated property. Such satisfaction could possibly precipitate a gain to the corporation on the distribution despite § 311(a).¹⁴⁹

B. *Assignment of Income Doctrine*

Another possible problem arises as a result of the committee report relating to § 311(a) which stated that the enactment of that section was not intended to change existing law which operates to attribute shareholders' income to their corporation.¹⁵⁰ The report, as an example, cites *Commissioner v. First State Bank*¹⁵¹ in which certain notes which had previously been written off as bad debts were distributed to the shareholders at a time when they were considered at least partially collectible. The court held that the collections by the shareholders should be considered taxable to the corporation since there was an anticipatory assignment of income.

It is clear that the decision in that case was based purely on assignment of income principles in that the note, because it was previously written off, lost its status as a capital asset and became purely potential income. It is clear that such income must be taxed to the assignor, as in the landmark case of *Helvering v. Horst*,¹⁵² where it was held that interest collected on a bond coupon which had been detached from the bond and assigned to another was includible in the income of the owner of the bond.

The court was careful to distinguish cases like *General Utilities and Operating Co. v. Helvering*¹⁵³ in which a note not previously written off was distributed. It stated that in the *General Utilities* case, "the fruit was on the tree" but in the instant case "the tree itself represents fruit of prior years that was not taxed" and further found that "[t]he distinction is the same as would have existed . . . if the father [in *Horst*] had given his son the bond with the unearned-interest coupon attached."¹⁵⁴ Thus, it seems clear that the assignment of income doctrine cannot apply in this or any other context if the capital asset itself is transferred at a time when there is no inherent income already accrued. For this reason,

149. *Bacon-McMillan Veneer Co.*, 20 B.T.A. 556 (1930).

150. S. REP. NO. 1622, 83d Cong., 2d Sess. 246 (1954).

151. 168 F.2d 1004 (5th Cir.), *cert. denied*, 335 U.S. 867 (1948) [hereinafter referred to as *First State Bank*].

152. 311 U.S. 112 (1940).

153. 296 U.S. 200 (1935).

154. *Commissioner v. First State Bank*, 168 F.2d 1004, 1009 (5th Cir.), *cert. denied*, 335 U.S. 867 (1948).

where there is a transfer of an asset which contains unrealized appreciation, the gain potential inherent in it may not be considered income to the transferor under the assignment of income doctrine since *both* the fruit and tree have been disposed of.¹⁵⁵

Under this analysis, the distribution in kind of appreciated stocks or securities held by the corporation could not precipitate a gain to the corporation under the assignment of income doctrine as set forth in the *First State Bank* case referred to in the committee report. Because the report cites this case, a cogent argument could certainly be made that the statement in the committee report is limited to attribution of shareholders' income to their corporation based on assignment of income principles. If such an argument prevailed, the distribution of appreciated assets could be made with no danger of gain recognition at the corporate level.

C. Attribution of Shareholder Sales to the Corporation Where There Is a Tax Avoidance Motive or the Sale Was in Reality Made by the Corporation

There is another line of cases, however, which may have been preserved by the committee report. *Commissioner v. Court Holding Co.*¹⁵⁶ involved a corporation about to undergo complete liquidation. Negotiations had been conducted for the sale of all corporate assets and the deal was about to be consummated when it was discovered that a sale by the corporation would precipitate a capital gain at the corporate level. For this reason, it was decided that the corporation should be liquidated in order to have the shareholders sell the assets on the same terms as had been previously negotiated by the corporation. The court held that under these circumstances, the corporation must recognize the gain.

Five years later, the Supreme Court limited the *Court Holding Co.* decision in *United States v. Cumberland Public Service Co.*¹⁵⁷ There the corporation and its shareholders were involved in negotiations to sell the corporate operations. The taxpayer refused from the inception of the dealings with the purchaser to allow the corporation to sell the assets because it would produce unfavorable tax consequences in the nature of a gain at the corporate level. As a result, the corporation was liquidated and the shareholders made the sale. The court found that the sale was in fact made by the shareholders and that this case was distinguishable from *Court Holding Co.* since the negotiations by the corporation to sell the assets directly were avoided from the inception, and not called off at the last minute. The court expressly stated that the finding by the trial

155. See *Campbell v. Prothro*, 209 F.2d 331 (5th Cir. 1954) holding to this effect with respect to calves which were inventory items of considerable value and had no cost basis at the time of transfer.

156. 324 U.S. 331 (1945) [hereinafter referred to as *Court Holding Co.*].

157. 338 U.S. 451 (1950) [hereinafter referred to as *Cumberland*].

court that tax avoidance was a major motive for structuring the transaction in this manner was not material.

If the holding of *Cumberland* applied in the instant situation, it would be simple to avoid any gain at the corporate level since there is no negotiation involved in selling relatively small amounts of publicly traded securities. They could merely be distributed to the shareholders who would, in turn, sell them through their brokers. However, that decision and its statement that tax avoidance motive is immaterial may be limited to liquidating distributions,¹⁵⁸ particularly in light of the language of the opinion stating that "[t]he corporate tax is thus aimed primarily at the profits of a going concern."¹⁵⁹

In *Commissioner v. Transport Trading and Terminal Corp.*,¹⁶⁰ involving a non-liquidating distribution in kind, the court stated, in effect, that its holding that the gain on the sale must be recognized at the corporate level could be based merely on the fact that the distribution served no non-tax purpose. Despite this broad language, it was unnecessary to go so far in this case since there were substantial negotiations regarding the sale conducted at the corporate level as there were in the *Court Holding Co.* case. Another case, *United States v. Lynch*,¹⁶¹ relying heavily on *Transport Trading*, held that the gain must be reported at the corporate level where inventory distributed to shareholders was subsequently sold utilizing the corporate selling facilities. Although its decision did not rest on this fact, the court here also stated that "[d]istribution of corporate inventory with the expectation of immediate sale by the shareholders pointedly suggests a transaction outside the range of commercially-motivated and justifiable activity. . . ."¹⁶²

The foregoing cases may, of course, be distinguished from the plan proposed here in that under this plan there will be no use of corporate sales facilities, no distribution of inventory, and no pre-distribution negotiations by the corporation. Nevertheless, the Tax Court in a more recent case¹⁶³ termed these very distinctions "tenuous" where a motive to avoid the corporate income tax was present. In addition, the court expressly held that in light of the committee report mentioned above, § 311(a) did not prevent recognition of gain at the corporate level, and that the failure of the report to mention the *Lynch* case by name does not preclude its application.

Despite the court's hostility toward the tax avoidance motive, the

158. Congress has enacted § 337 which allows a corporation to sell its assets and then liquidate the proceeds without recognition of gain on the sales at the corporate level if certain requirements are met. INT. REV. CODE OF 1954, § 337.

159. *United States v. Cumberland Pub. Service Co.*, 338 U.S. 451, 455 (1950).

160. 176 F.2d 570 (2d Cir. 1949), *cert. denied*, 338 U.S. 955 (1950) [hereinafter referred to as *Transport Trading*].

161. 192 F.2d 718 (9th Cir. 1951), *cert. denied*, 343 U.S. 934 (1952) [hereinafter referred to as *Lynch*].

162. *Id.* at 720.

163. *A.B.C.D. Lands, Inc.*, 41 T.C. 840 (1964).

decision seemed to rest mainly on the fact that there was a use of corporate sales facilities to market the distributed inventory in the ordinary course of business. Thus, in the instant plan, the foregoing distinctions could presumably hold up even if a tax avoidance motive exists. This approach is supported by a recent Fifth Circuit decision, *Hines v. United States*, which expressly adopted these very distinctions and held that "the *sine qua non* of the imputed income rule is a finding that the corporation actively participated in the transaction that produced the income to be imputed."¹⁶⁴ In so holding, the court found immaterial the facts that the distribution was made by a going concern in anticipation of a sale by the shareholders and that there was no valid business purpose for the distribution aside from tax avoidance.

There is another recent case which may be construed to de-emphasize the existence of the motive to avoid taxes.¹⁶⁵ There the court recognized what seemed to be a rather flimsy business purpose and deemed it "primary" although the transaction resulted in a substantial tax savings.

Although the treatment of distributions in kind may still be somewhat uncertain, unless a business or other non-tax purpose for the distribution can be developed or there is no sale or exchange of the distributed property shortly after the occurrence of the distribution, the *Hines* case seems to go a long way toward eliminating these problems. Nevertheless, a conservative planner may wish to have the corporation make regular property distributions in excess of current earnings for the purpose of defraying some of the living expenses of the shareholder in order to help negate the appearance of a tax avoidance motive. The particular circumstances of the parties involved should be examined for other nontax purposes for making property distributions.

Also, if there is no sale of the distributed assets soon after the distribution, the risk of corporate capital gain may be further reduced. The interval required is not certain, but it certainly would be difficult to attribute the gain to the corporation if the interval were one or two years. Authority for this proposition may be found in the tax court's statement in *A.B.C.D. Lands, Inc.*¹⁶⁶ that the absence of a consensus or understanding between the corporation and shareholders "that the assets distributed would be sold *immediately upon distribution*" is indicative that there should be no gain attributed to the corporation.¹⁶⁷ Additionally, in *Dynamics Corporation of America v. United States*¹⁶⁸ the court was persuaded not to attribute gain to the corporation by the fact that the sale did not occur until nine months after the distribution. The inability to sell right away with minimal tax cost may remove some advantages of

164. 477 F.2d 1063, 1069 (5th Cir. 1973) [hereinafter referred to as *Hines*].

165. *Dynamics Corp. of America v. United States*, 449 F.2d 402 (Ct. Cl. 1971).

166. 41 T.C. 840 (1964).

167. *Id.* at 851 (emphasis added).

168. 449 F.2d 402 (Ct. Cl. 1971).

the plan,¹⁶⁹ but some degree of flexibility is still retained while capital gain taxes are kept low.

Prior to the decision in the *Hines* case, the risks in this area might have caused the conservative advisor not to use the plan, since it could have been too costly in terms of capital gain taxes to make adjustments in the corporate portfolio. Despite these facts, past history may have shown that there were few sales and the client might not have contemplated numerous future sales, or other circumstances may have reflected that, even if some gain must be recognized at the corporate level, the double taxation effect would not have been so burdensome as to have outweighed the advantages of the plan. Now, however, the risk of corporate capital gains has been substantially reduced, and accordingly, the plan may be much more attractive—even to the conservative planner.

D. Sales of Securities Which Will Produce Losses

The handling of sales of securities that will produce losses should be similar to that which should be used for those which will produce gains in most cases. It should be noted, however, that if the securities that will be sold at a loss are distributed prior to their sale, the distributee-shareholder will have little or no "tax loss" if he sells them shortly after the distribution because their basis in his hands will be approximately equal to the selling price.¹⁷⁰ For this reason, it may be wise to realize losses at the corporate level if they can be used within the carryback or carry-over periods.¹⁷¹

VIII. OTHER METHODS OF REMOVING PROPERTY FROM THE CORPORATION—REDEMPTIONS AND COMPLETE LIQUIDATIONS

A. Redemptions

1. EFFECT ON THE SHAREHOLDER

At the shareholder level, § 302(a) sets out the general rule that if certain conditions are met, the redemption of a shareholder's stock will be treated as a distribution in payment or exchange for the stock. Section 302(b) sets out certain technical rules for determining whether the distribution will be treated as a dividend or a sale or exchange.

A recent case¹⁷² as well as the attribution rules of § 318 make avoidance of dividend treatment in a closely held family corporation extremely difficult. Accordingly, the only type of redemption which, as a practical matter could result in sale or exchange treatment under this plan is a complete termination of a shareholder's interest under § 302(b) (3). Because of the probable family relationships between the share-

169. See section II(G)(1) *supra*.

170. INT. REV. CODE OF 1954, § 301(d).

171. INT. REV. CODE OF 1954, § 1212(a).

172. *United States v. Davis*, 397 U.S. 301 (1970).

holders in this situation, the use of a complete redemption would be dependent on qualification for waiver of the family attribution rules.¹⁷³ This requires satisfaction of the detailed provisions of § 302(c)(2) which prevent the redeemed shareholder from associating himself with the redeeming corporation in any capacity, other than as a creditor, for ten years after the occurrence of the redemption. If earnings and profits are not kept low, this type of redemption may have some application here, provided that the rigid requirements of § 302(c)(2) can be met.

Section 303 may also be used in special circumstances to qualify a redemption for sale or exchange treatment. This section contains extremely rigorous and technical rules for determining its applicability, but in general it may be used only where the stock in question had been included in an estate for federal estate tax purposes and only to the extent of the estate and inheritance taxes plus funeral and administrative expenses relating to the estate in question. If the owner-transferor or another shareholder of the incorporated portfolio dies, this section may have some limited application.

2. EFFECT ON THE CORPORATION

Section 311(d) provides the general rule that when appreciated property is used to redeem stock, a gain will be recognized to the corporation. Exceptions, however, are provided for the two types of redemptions discussed above (*i.e.*, under § 302(b)(3) or § 303).¹⁷⁴ For this reason, a redemption will normally have no effect at the corporate level in this situation unless one of the problems discussed in section VII *supra* arises.

B. Complete Liquidations

1. EFFECT ON THE SHAREHOLDER

Section 331 provides that the shareholder receiving corporate property in a liquidation will be treated as having exchanged his stock for the property received. As stated previously¹⁷⁵ a complete liquidation could normally be effected on an installment basis if, as recommended, the earnings and profits of the corporation are kept low; however, for the purposes of completeness, the liquidation provisions will be briefly considered.

Normally, a complete liquidation would not be desirable since the shareholder must recognize gain to the extent of the appreciation in the value of his stock in one or two taxable years. In addition, election under § 333 will not provide any relief here since the entire assets of the corporation should normally consist of money, and stock and securities acquired

173. These attribution rules are set out in INT. REV. CODE OF 1954, § 318(a)(1).

174. INT. REV. CODE OF 1954, § 311(d)(2)(A).

175. Section II(H) *supra*.

after 1953.¹⁷⁶ It should be noted that the date acquired for this purpose is the date of actual transfer to the corporation even if the holding period of the stock or securities in the hands of the corporation begins prior to that time.¹⁷⁷

2. EFFECT ON THE CORPORATION

Section 336 sets out the general rule that no gain or loss is recognized at the corporate level where there is a complete liquidation. However, the *Court Holding Co.* case¹⁷⁸ and other decisions discussed in section VII, *supra*, may present some problems in this area. One advantage of complete liquidation over the informal installment liquidation suggested above¹⁷⁹ is that the difficulties resulting from these cases may be avoided if the transaction meets the requirements of § 337.¹⁸⁰ In addition, it is likely that liquidation may, through careful planning, be brought within the ambit of the *Cumberland* case even if § 337 does not apply.¹⁸¹

IX. EMPLOYEE BENEFIT PLANS

Although a complete discussion of employee benefit plans is beyond the scope of this article, some of the problems arising as a result of the particular nature of the incorporated portfolio will be briefly considered. Although there are other types of fringe benefit plans¹⁸² the treatment here will be limited to qualified plans¹⁸³ and medical expense reimbursement plans since this writer believes that these are the types which could most practically be adopted in the instant situation.

If such plans can effectively be adopted, an additional tax benefit would result from forming a corporation to hold securities since such plans may not normally be used by individuals operating as proprietorships or partnerships.¹⁸⁴

176. INT. REV. CODE OF 1954, § 333(e)(2).

177. Rev. Rul. 58-92, 1958-1 CUM. BULL. 174.

178. 324 U.S. 331 (1945).

179. Section II(H) *supra*.

180. This section prevents gain recognition at the corporate level where the liquidation is completed within twelve calendar months of the adoption of a plan of liquidation and certain other technical requirements are satisfied. For a full discussion of this provision, see BIRTNER & EUSTICE, *supra* note 2, ¶ 11.64-.71.

181. 388 U.S. 451 (1950). See section VII(C) *supra*.

182. For example, group term life insurance is provided for in INT. REV. CODE OF 1954, § 79.

183. INT. REV. CODE OF 1954, § 401.

184. The reason for this is that to enable the use of these fringe benefit plans there must be an employer-employee relationship. Note, however, that so-called owner-employees may be permitted to use self-employed retirement plans which are much more limited than other qualified retirement plans. See INT. REV. CODE OF 1954, § 401 and the regulations thereunder. *But see* *Armstrong v. Phinney*, 394 F.2d 661 (5th Cir. 1968) which may provide an argument that partners and sole proprietors may use fringe benefit plans more extensively.

A. *The Use of Qualified Plans*

The tax advantages of using qualified plans is well known. The employer receives a current deduction for contributions to a trust established under such a plan¹⁸⁵ and these amounts are not taxable to the employee until they are distributed to him from the trust.¹⁸⁶ In addition, the earnings of the trust are normally tax-free since the trust, if qualified, is an organization exempt from federal income tax.¹⁸⁷

The major problem which arises in this situation is assuring qualification of the plan under § 401 in light of the fact that the only employees of the corporation are likely to be its shareholders. One basic requirement for qualification is that the plan be for the benefit of employees in general and may not discriminate as to eligibility or benefits in favor of employees who are officers, shareholders, highly compensated employees, or supervisors (frequently referred to as the prohibited group).¹⁸⁸

The following statement from one revenue ruling seems to indicate that even a sole shareholder-employee *may* in some untold circumstances be the only beneficiary of a qualified plan.

A plan will *not necessarily* fail to qualify merely because it covers only the employer's one employee, provided, however, that it is not designed or operated as a means of siphoning profits to a shareholder-employee or otherwise limiting participation to an employee within a class in whose favor discrimination is prohibited under Section 401(a)(3)(B) and (4) of the Code.¹⁸⁹

Grave doubt has been cast upon the efficacy of this provision by the holdings of certain cases and other revenue rulings. One ruling¹⁹⁰ found that the plan in question was not qualified where the nature of the employer-corporation's business and its hiring practices, in combination with the terms of the plan, operated to effectively exclude all employees other than the sole shareholder. It may be argued, however, that the facts of this ruling are distinguishable, particularly if the plan is written in such a way as to provide for inclusion of any new employees. In any event, the hiring practices in the instant case would not operate to prevent possible future employees from participating in the plan.

Greenwald v. Commissioner,¹⁹¹ however, may limit the effectiveness of such arguments. In that case all the assets of an active corporation

185. INT. REV. CODE OF 1954, § 404.

186. INT. REV. CODE OF 1954, § 402.

187. INT. REV. CODE OF 1954, § 501(a).

188. INTERNAL REVENUE SERVICE, GUIDES FOR QUALIFICATION OF PENSION, PROFIT SHARING, AND STOCK BONUS PLANS, pub. 778, part 4(a) (Feb. 1972).

189. *Id.* (emphasis added).

190. Rev. Rul. 63-103, 1963-1 CUM. BULL. 87.

191. 366 F.2d 538 (2d Cir. 1966) [hereinafter referred to as *Greenwald*].

were sold, and 59 of the 60 employees left the corporation, most of them being employed by the acquiring firm. Part of the proceeds from the sale were then used to redeem the shares of all the shareholders other than those owned by taxpayer and his family, and the remaining funds were invested in stocks, bonds, notes, mortgages, and real estate. The Second Circuit found that the previously existing "salaried only" profit sharing plan was no longer qualified since the trust was being "operated only for the benefit of one man: the taxpayer"¹⁹² and that it was not likely that other employees would be hired since, because of the nature and size of the business, the company had "no need of—and could not well afford—more salaried employees."¹⁹³

The facts of the *Greenwald* case coincide closely with those of the instant situation as both involve family investment corporations. A weak distinction could be made on the basis that a salaried only plan would not be used by the incorporated portfolio. Since *Greenwald* disqualified the plan on the basis that it was discriminatory, the logic of the case may be criticized on the ground that the basic concept of discrimination must involve affording of preferential treatment to one or more employees *to the exclusion of others*, and since that case involved only one employee, how could discrimination exist?¹⁹⁴ Whether such an argument would succeed in permitting qualification in the instant situation is anything but certain.

Another poorly reasoned decision in this area is *Charles E. Smith & Sons Co. v. Commissioner*.¹⁹⁵ The court held that a pension trust was not qualified where the only person participating in the plan was the sole shareholder-employee who was also the corporate president, because the court found that the plan was not for the exclusive benefit of its employees. The court "reasoned" that because of the high degree of control that the sole shareholder exercised over the corporation, he was, in effect, the employer as well as the employee, and accordingly the pension plan was benefiting the employer as well as the employee. The fallacies of such reasoning seem obvious, and one commentator termed the case "an aberration."¹⁹⁶

In light of the authorities discussed above, the planner must carefully consider whether or not to have the corporation adopt a qualified plan. In making this decision, consideration must be given to many practical questions such as: What is the likelihood that the plan will be approved upon submission of an application for determination (Form 4573)? What chance is there that the qualification of the plan will later be successfully attacked? Does the dollar amount of the expected tax benefits justify taking these risks? Is the client psychologically attuned to the

192. *Id.* at 540.

193. *Id.*

194. COMMERCE CLEARING HOUSE, INC., PENSION PLAN GUIDE ¶ 2346 (2d ed. 1971).

195. 184 F.2d 1011 (6th Cir. 1950), *cert. denied*, 340 U.S. 953 (1951).

196. COMMERCE CLEARING HOUSE, INC., PENSION PLAN GUIDE ¶ 2293.12 (2d ed. 1971).

possibility of disqualification of the plan after a favorable initial determination?

B. *The Use of Medical Expense Reimbursement Plans*

Section 105 permits an employee to exclude amounts received under an accident or health plan for employees, and § 162(a) permits the employer to deduct such amounts as business expenses provided they are "ordinary and necessary."¹⁹⁷ There has been some reported litigation regarding the use of such plans in closely held corporations. The absence of an express prohibition against discrimination in the code or regulations, as well as certain legislative history¹⁹⁸ indicate that such plans may be discriminatory and still receive the favored tax treatment discussed above.¹⁹⁹ The most difficult requirement for exclusion under § 105 has been that there be a "plan for employees." Since the payments pursuant to such a plan are in the nature of compensation, it is also necessary that they be "reasonable" in order to satisfy the ordinary and necessary requirement for deduction by the employer.²⁰⁰

1. THE "PLAN" REQUIREMENT

Although the plan need not be written and the employee's rights to benefits under it need not be enforceable so long as it was communicated to them, a plan must nevertheless exist. The amounts to be paid and conditions of payment may not be determined on an ad hoc basis or they will be included in the employee's income.²⁰¹ The plan requirement can be satisfied merely by writing a formal plan with specific provisions as to the amounts and conditions of payment, and having it adopted at a director's meeting and placed in the corporate minute book.

2. THE "FOR EMPLOYEES" REQUIREMENT

The plan must be for the benefit of corporate employees in their capacity as such.²⁰² This requirement is somewhat nebulous, but the gist of it is to preclude exclusion from the employee's income where the payments are intended to be made to a person because he is a shareholder, and not because he is an employee. Although this determination must be made in light of all the surrounding circumstances, the following factors have been considered in disallowance of exclusions claimed under this section: (1) whether the plan covers shareholder-employees in proportion to their stockholdings, and (2) whether the shareholder-

197. Treas. Reg. § 1.162-10(a) (1958).

198. H.R. REP. NO. 2543, 83d Cong. 2d Sess. 24 (1954).

199. *Bogene, Inc.*, P-H TAX CT. MEM. DEC. ¶ 68,147 (1968).

200. See INT. REV. CODE OF 1954, § 162(a) and the regulations thereunder.

201. *Larkin v. Commissioner*, 394 F.2d 494 (1st Cir. 1968).

202. *Bogene, Inc.*, P-H TAX CT. MEM. DEC. ¶ 68,147 (1968).

employees are related.²⁰³ In the instant situation, the shareholder-employees are almost certain to be related and the passive nature of the business will make it difficult to justify, either economically or from a tax standpoint, the employment of additional unrelated personnel in an attempt to assure that the plan meets the necessary requirements. The risk of adopting such a plan, however, is not great if the corporation adopts a formal plan which conforms as closely as possible to the foregoing rules, and it adopts a hedge agreement as a precautionary measure.²⁰⁴

C. *The Unreasonable Compensation Problem*

Inherent in the consideration of fringe benefit plans in connection with a closely held corporation is the problem of unreasonable compensation. Since the economic benefits conferred under these plans is in the nature of additional compensation, they must be reasonable in order to qualify for deduction under § 162. The determination of reasonableness is necessarily a question of fact to be determined by all the surrounding circumstances,²⁰⁵ and there are therefore no hard and fast rules for ascertaining whether compensation is reasonable. Although the amount of work connected with operating an investment company will vary depending on the size, quality, and activity of the portfolio, it would seem that the amount of compensation that would be deemed reasonable would definitely be limited.

This fact should therefore be kept in mind when terms of fringe benefit plans as well as the amount of direct compensation is being considered. Also pertinent is the fact that compensation received is normally taxable to the recipient irrespective of the deductibility by the employer.²⁰⁶ For this reason, a so-called hedge agreement whereby the employee must repay the corporation for any amounts determined by the government to be unreasonable should be adopted. If certain requirements are met, the agreement will permit the employee to deduct the amount repaid as an ordinary and necessary employment-connected expense.²⁰⁷

X. VALUATION OF CLOSELY HELD STOCK FOR FEDERAL ESTATE AND GIFT TAX PURPOSES

A. *Valuation—A Question of Fact*

Valuation of stock in a closely held corporation for federal estate and gift tax purposes is anything but a clear cut process. It is a question

203. *Id.*

204. See section IX(C) *infra*.

205. Treas. Reg. § 1.162-7(b)(3) (1958).

206. Treas. Reg. § 1.162-8 (1958).

207. For the details of the requirements of such an agreement, see Vincent E. Oswald, 49 T.C. 645 (1968); Rev. Rul. 69-115, 1969-1 CUM. BULL. 50.

of fact to be determined by the circumstances of each case. Since Revenue Ruling 59-60²⁰⁸ considers valuation for gift and estate tax purposes together, it seems that the same valuation procedures would be applied for the purposes of both types of taxes. That ruling sets out a number of criteria for valuation. It begins by emphasizing that valuation of stock in a closely held corporation is a factual question and proceeds to state that the appraiser should recognize

that valuation is not an exact science [and that a] sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance.²⁰⁹

B. *Degree of Corporate Control and Marketability of Shares*

A number of basic rules for valuation are also set out in that ruling. One important factor is the degree of control which the stock represents. Minority interests in a closely held corporation may be difficult to sell and therefore a discount from underlying asset value may be warranted in valuing such stock. Likewise, a controlling interest (actual or effective) may justify a higher value. In support of this proposition, one case²¹⁰ held that minority interests in closely held stock are usually worth much less than the proportionate share of underlying asset value, and on that basis allowed a 35 percent discount to be applied to that amount in valuing the stock. Another case²¹¹ found that the valuation of shares in a family corporation must be adjusted upward where they represent the controlling interest in the corporation. These cases reflect that even if some discount were allowed with respect to the shares in a closely held "incorporated portfolio," the amount thereof would be somewhat reduced in a case where the owner-transferor continued to control the corporation until his death.

Careful planning may avoid some of the risk of a higher estate tax valuation of the preferred stock created in this situation by the owner-transferor's control of the corporation. *Obermer v. United States*²¹² whose facts coincide closely with those of the plan proposed here reveals some possibilities in this area. The corporation involved was a holding company which owned mainly marketable securities, and the stock was held 50 percent by decedent and 50 percent by his wife. The fact that decedent's ownership was not sufficient to permit him or his estate to have the corporation liquidated at will weighed heavily in the court's decision to allow a 33⅓ percent discount from the asset value of the stock.

208. 1959-1 CUM. BULL. 237 [hereinafter referred to as Revenue Ruling 59-60].

209. *Id.* at 238.

210. *Drybrough v. United States*, 208 F. Supp. 279 (W.D. Ky. 1962).

211. *Blanchard v. United States*, 291 F. Supp. 348 (S.D. Iowa 1968).

212. 238 F. Supp. 29 (D. Hawaii 1964) [hereinafter referred to as *Obermer*].

Even if provisions of local law would not prevent the owner-transferor from liquidating the corporation, the corporate charter (articles of incorporation) or by-laws could normally be made to require the consent of a majority of all classes of stock in order to make the facts coincide closely with those in *Obermer*. To make the facts even more similar to those in *Obermer*, the owner-transferor could arrange to own the shares 50-50 with his wife. The gift tax cost and the effect on the owner-transferor's overall estate plan should be carefully considered, however, before this course of action is adopted. It should be noted that such splitting of the stock could have the effect of mitigating the dangers of inclusion of all corporate assets in the owner-transferor's estate under § 2036(a) or § 2038.²¹³

In making its determination to allow the 33⅓ percent discount, the court in *Obermer* took into account the following factors which seem to be favorable for allowing a lower valuation of the stock of the "incorporated portfolio."

(1) The fact that the corporation was a personal holding company subject to onerous taxes unless all its earnings were distributed was one factor which justified the discount.

(2) The corporation in *Obermer* owned substantially appreciated securities which could not be sold without the necessity of paying a large capital gains tax. This heavy tax burden which would have been placed on the corporation in the event of a sale helped persuade the court to allow the lower valuation.

C. *The Effect of the Value of the Underlying Assets*

Also pertinent is the statement in Revenue Ruling 59-60 that in valuing the shares of an investment holding company, the value of the underlying assets of the corporation should be given great weight. Thus, it would seem that a reasonable approach to valuing the shares of a corporation holding marketable stocks and securities would be to start with underlying asset value and make adjustments for marketability of the shares, the degree of control they represent, and the other factors discussed above.

D. *Comparison with the Value of Shares of Other Similar Corporations*

Valuation of stock of companies engaged in similar businesses is another factor Revenue Ruling 59-60²¹⁴ suggests should be taken into account. In this connection, it is a well known fact that the stocks of mutual funds which are engaged in holding and investing in stocks and securities frequently sell at substantial discounts from the underlying

213. See section XI *infra*.

214. 1959-1 CUM. BULL. 237, 239.

value of their portfolios.²¹⁵ Certainly the activities of this type of business are similar to those of the corporation planned in this article; however, there are also important distinctions.

First, the size of a mutual fund is far greater, and the shares are more marketable than those of a small corporation holding stocks and securities. Second, the management of a mutual fund theoretically has a great deal of expertise in handling this type of business. These facts would logically tend to justify a larger discount in the case of a closely held investment company.

This rationale is supported by at least one decided case²¹⁶ which involved the valuation of stock representing a 23.5 percent interest in the stock of a family owned corporation which held marketable stocks and bonds. A 25 percent discount from underlying asset value was allowed primarily on the basis of comparisons with publicly held corporations having similar activities.

The court also stated that as a general rule the market value of a listed stock is less than the assets value of such stock. It should be noted, however, that this case involved the valuation of a minority interest. In addition, a showing that the stock of specific public companies reflected a discount from net asset value at the time death occurred was apparently required. It should also be noted that in *Obermer* the comparison to a mutual fund for the purposes of valuing shares held by the estate was rejected.

E. *Summary and Conclusions Relating to the Valuation Problem*

In any event, there seems to be substantial authority for discounting the value of the shares in the incorporated portfolio to some extent. The amount the valuation is lowered will depend on all the facts and circumstances of each situation, the availability of information to support the discount, and the relative abilities of the advocates representing the government and the taxpayer.

XI. THE DANGER OF INCLUSION IN THE OWNER-TRANSFEROR'S GROSS ESTATE UNDER § 2036(a) OR § 2038

When a person makes a gratuitous transfer but retains certain "tainted" powers over the property transferred, § 2036(a) and § 2038 may operate to include such property in the transferor's gross estate in spite of the fact that he has "given it away." These sections may apply to the transfer of the common stock under the plan in the instant case because the owner-transferor has retained all the voting control of the corporation.

215. *Blackard v. Jones*, 62 F. Supp. 234, 236 n.2, (W.D. Okla. 1944), *Vass, Factors That Are Presently Being Emphasized in Valuing a Closely-held Corporation*, 38 J. TAX. 356 (1973).

216. *Blackard v. Jones*, 62 F. Supp. 234 (W.D. Okla. 1944).

A. *Retention of Administrative Control by the Owner-Transferor*

The possible application of § 2036(a) is illustrated by a recent United States Supreme Court case, *United States v. Byrum*.²¹⁷ In that case, a decedent transferred stock in certain corporations which he controlled to an irrevocable trust naming a corporate trustee and retaining the following powers:

(1) The right to continue to vote the stock in the trust which, in combination with the shares he continued to own, gave him a controlling interest in all the corporations;

(2) the right to remove the trustee and reappoint another corporate trustee at any time;

(3) the right to disapprove any disposition of the stock transferred to the trust.

The Court decided that, despite these facts, the transferred stock should not be included in decedent's estate under § 2036(a). However, there was an additional factor present—a substantial unrelated minority interest in the ownership of the stock of the corporation. It is not clear what weight the Court placed on this or any of the other facts in making its decision, but until the decision is further interpreted, caution should be exercised in extending it beyond its facts.²¹⁸

One important distinction that may be drawn from the plan in the instant case is that the unrelated minority interest will probably not be present. This of course would make the owner-transferor's degree of control greater than in *Byrum*. It should be noted, however, that there is additional authority in this area which does not seem to require the existence of any outside interest. In *Yeazel v. Coyle*²¹⁹ the sole shareholder of a corporation transferred 60 percent of her shares to an irrevocable trust of which she was the trustee and retained the power to vote all the shares held by the trust. Under these facts the court found that only the named beneficiaries could receive the benefit of the transferred shares, and therefore the transferor had no power to "enjoy" or "designate" which would require inclusion under § 2036(a).²²⁰

Because of the outright transfer of the common shares, two unfavorable factors in *Byrum* would not be present in the instant case: (1) the right of the transferor to veto any dispositions of the shares, and (2) the right to change the trustee. In addition, a minority interest, although probably related to the owner-transferor, would nevertheless exist in the form of the common shareholders.

217. 408 U.S. 125 (1972) [hereinafter referred to as *Byrum*].

218. See *id.* at 151-68 (dissenting opinion); 26 U. MIAMI L. REV. 652 (1972).

219. 68-1 CCH U.S. TAX CAS. ¶ 12,524 (N.D. Ill. 1968).

220. See also Estate of George H. Burr, P-H TAX CT. MEM. DEC. ¶ 45,364 (1945) where stock transferred by a decedent was not included in his estate even though he retained an option to acquire substantial amounts of unissued stock in the same corporation.

B. Control and Enjoyment of Income from the Transferred Stock

Another positive factor is that, as a practical matter, the corporate earnings would have to be distributed to the shareholders, including the common shareholders, because of the personal holding company provisions.²²¹ If these earnings were not so distributed, the minority shareholders could probably compel such distribution in order to avoid the prohibitive tax through a derivative action.²²² To assure that the common shareholders would have such rights, provision could be made in the articles of incorporation for voting rights to vest in the common shareholders after any year in which any part of the corporate net earnings is not distributed. It should also be noted that the articles of incorporation could give the non-voting common the right to receive notice of any proposals for major corporate changes such as mergers, sales of entire corporate assets, or complete liquidation, even though the shares would normally not be entitled to vote. To assure that the common shareholders' investment has liquidity, buy-sell agreements with arms-length terms could be executed. Such an agreement should permit any shareholder, at his election, to either dispose of his stock or acquire a controlling interest in the corporation at any time. All of these factors would tend to establish the fact that the interest of the common shareholders is a true property right which is not subject to the whim of the owner-transferor.

C. Exercise of Administrative Powers and Limitations Thereon by "External Ascertainable Standards"

It would certainly seem that under these circumstances, the owner-transferor would be subject to an "external ascertainable standard" in exercising whatever powers he would have over the transferred property. In *Jennings v. Smith*,²²³ such circumscribed powers were not considered tainted under § 2038. This same rationale should be applicable by analogy to § 2036(a) powers. Certainly, the owner-transferor's voting control, if limited as suggested above, is not nearly as broad as the decedent's "sole discretion" as a trustee to accumulate or pay out trust income which caused inclusion under § 2036(a) in *United States v. O'Malley*.²²⁴

In another case²²⁵ the court held that the mere ability of the transferor to delay the distribution of the benefits of the transferred property to the ultimate beneficiary was sufficient to cause inclusion of the transferred property as a "power to designate" under § 2036(a)(2). The owner-transferor under the plan in the instant case, however, does not have the power to materially affect the timing of the receipt of the benefits from the transferred property since dividends would be required

221. See section V *supra*.

222. See e.g., FLA. STAT. § 608.131 (1973).

223. 161 F.2d 74 (2d Cir. 1947).

224. 383 U.S. 627 (1966), distinguished in *United States v. Byrum*, 408 U.S. 125 (1972).

225. *Estate of Hector R. Skifter*, 56 T.C. 1190 (1971), *aff'd*, 468 F.2d 699 (2d Cir. 1972).

to be paid currently by virtue of the contingent voting rights in the common shareholders, and the buy-sell agreement would provide the common shareholders with the ability to liquidate their investment without great difficulty. The retained powers in this case could be analogized to the mere administrative powers in *Old Colony Trust Co. v. United States*²²⁶ which were held *not* to bring the transfer within § 2036(a). The court in that case emphasized the fact that the exercise of the administrative powers was subject to external review by the courts just as an abuse of the owner-transferor's control would be in the instant case.

D. *The Right of the Owner-Transferor to Salary*

In *Byrum*, it was argued that the voting power gave the decedent the right to income from the transferred property. Although this argument did not prevail in that case, two other cases may be of interest in this area. *Estate of William F. Hofford*²²⁷ and *Estate of Pamela D. Holland*²²⁸ involved transfers of stock with the retention of the right to a salary from the corporation. In the former case in which the stock was not included, the transferor continued to render services to the corporation although the payment of the "salary" was not dependent thereon, but in the latter case no such services were rendered and inclusion was required. Also, in *Holland*, the payment of the salary was secured by the transferred stock. One writer states that

the thin line of distinction which separates . . . [the Hofford case] from the Holland case illustrate[s] the peril of making gifts of stock in a family corporation and the extent to which the Treasury may go to claim a tax under Sections 2036 and 2037.²²⁹

The "peril" of the situation may be alleviated to some degree by requiring in the articles of incorporation that a hedge agreement shall be required with respect to any salary paid to the owner-transferor.²³⁰ This would seem to subject the payment of salary to an ascertainable external standard and require that payment be made only for bona fide services rendered, rather than as an incident to the transfer of the stock. Of course, the owner-transferor should not have the ability to change the requirement that such an agreement exist.

E. *Conclusions and Recommendations*

Despite the fact that the transaction may be structured as explained above in order to allow the owner-transferor to retain voting control of

226. 423 F.2d 601 (1st Cir. 1970).

227. 4 T.C. 790 (1945) (supplemental opinion).

228. 47 B.T.A. 807 (1942).

229. C. LOWNDES & R. KRAMER, *FEDERAL ESTATE AND GIFT TAXES* 151 (2d ed. 1962).

230. Section VIII *supra*.

the corporation and avoid the application of § 2036(a) or § 2038, the fact that the voting control remains in the owner-transferor, does leave some uncertainty as to the application of these sections because of the government's attempt to apply these provisions very broadly, and the difficulty as a result of the broad base and unclear language of most decisions in this area of determining the attitude of the courts toward interpreting them.

There are two possible solutions to this problem. One is to attempt to avoid § 2036(a) and § 2038 initially by making the transfer of the non-voting common stock nongratuitous (*i.e.*, the common stock would be purchased for its fair market value). Since, as explained previously, that stock would be of nominal value, the purchase would not require a large amount of capital. However, care should be taken in determining the value of the stock to be purchased, and accordingly the possibility of a formal appraisal should be considered. In addition, the purchase price could be set at 25 to 30 percent higher than the established market value to further assure that the transfer is for full and adequate consideration. If the intended transferees are unable to pay the required consideration, it may be possible for the owner-transferor to make a gift to them of the necessary amounts. In that case, however, incorporation would have to be delayed for a substantial period of time to avoid the possible application of the step transaction doctrine which would combine the gift and the purchase of the stock for tax purposes.²³¹

A second possibility is to remove legal control of the corporation from the hands of the owner-transferor. This could be accomplished in any number of ways. One possible example is placing the voting preferred stock in an irrevocable trust and naming a friendly and responsible corporate trustee who would informally agree to follow the owner-transferor's advice on investment and other business decisions for the corporation. Another possibility is a provision in the trust instrument that preferred and common shareholders be represented equally on the board of directors. It is doubtful whether such arrangements would be subject to successful attack under § 2036(a) or § 2038.²³²

If as many as possible of the precautionary measures mentioned in the preceding discussion are used, it would seem likely that the arrangement should successfully avoid § 2036(a) and § 2038. However, should it be determined that these provisions apply, the owner-transferor would be in the same position as though the scheme had not been used,

231. This would result in the transfer of the non-voting common stock being gratuitous. For an illustration of the application of the step transaction doctrine *see, e.g.*, *American Bantam Car Co.*, 11 T.C. 397 (1948), *aff'd*, 177 F.2d 513 (3d Cir. 1949).

232. *Cf.* *Estate of Pamela D. Holland*, 47 B.T.A. 807 (1942), *supplemented by* 1 T.C. 564 (1943); *Estate of William F. Hofford*, 4 T.C. 542 (1945) (supplemental opinion); *Estate of James Gilbert*, 14 T.C. 349 (1950); *Estate of George L. Shearer*, 17 T.C. 304 (1951); *Ruby Louise Cain*, 37 T.C. 185 (1961).

and its use does not foreclose other estate planning devices such as private annuities, marital and non-marital trusts, or outright gifts of property.

XII. SUMMARY AND CONCLUSION

Most of this article has dealt with the details and technical requirements of forming an incorporated portfolio. Also discussed at some length are the expected tax and economic effects of the plan. It should be remembered, however, that the incorporated portfolio, like other estate planning techniques, must be suited to the individual for whom it is being considered. A person's financial condition or family situation may make the plan completely inapplicable. Moreover, the client may not be psychologically attuned to accepting the complications which will be injected into the ownership of his property.

Nevertheless, the incorporated portfolio may be attractive to many, although it is seldom if ever possible to predict with absolute certainty the outcome of a plan which may ultimately depend on decisions of the Internal Revenue Service and the courts. This writer believes that if it is structured as recommended, the incorporated portfolio has a substantial probability of accomplishing its stated objectives.